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No. 416

In the Supreme Court of the United States

OCTOBER TERM, 1970

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES W. AND DOROTHY F. STRADMAN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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tiorari to and including August 8, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether an attorney's loss on the worthlessness of stock in a corporate client, acquired to avoid the loss of the corporation as a client, is a loss on the worthlessness of a capital asset defined in Section 1221 of the Internal Revenue Code.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

STATEMENT

Respondent,[1] a partner in a Cleveland law firm and a specialist in the field of corporate finance and organization, was general counsel to the Richards Music Corporation. He had helped organize the corporation, and expected to furnish legal services to it in the future, since its management anticipated the acquisition and amalgamation of several musical instrument companies into a single organization offering a complete line of musical instruments. Respondent was assured by Paul E. Richards ("Richards"), chief executive

[1] All references to "respondent" are to Charles W. Steadman. Dorothy F. Steadman is a party to this action only because a joint income tax return was filed.

officer and principal stockholder of the corporation, that he would remain general counsel to the corporation so long as Richards was in control of the corporation. (Appendix A, *infra*, p. 8.)

In 1961, after the corporation had embarked upon a costly program of acquisitions and mergers, Richards' control was jeopardized. The American Research and Development Corporation of Boston had previously advanced the corporation $750,000, in exchange for debentures convertible into common stock, and three of the nine board of directors' seats. It now offered to purchase any new stock offered to raise additional capital, provided that the board was increased to ten members, five of whom would be selected by the debenture holders. Implicit in this offer was American's bid for effective control of Richards Music, resulting from its veto power on the board and its potential ownership of a majority of the shares by conversion of the debentures. American Research made it clear that if it gained control, it would make a change in management and transfer the corporation's legal business to its own Boston law firm. Respondent thus was aware that acceptance of the American Research offer was likely to result in the loss of the legal fees he earned as general counsel to Richards Music. (Appendix A, *infra*, pp. 9–10.)

To head off American Research's bid for control, a resolution was passed providing for the issuance of 140,000 new shares of Richards Music capital stock for $370,000, to be offered first to Richards Music's shareholders of record. Such shareholders other than respondent were willing to purchase 70,000 shares,

and respondent was able to purchase 32,000 shares for $80,000.[2] The remaining 38,000 shares, which were not taken up by shareholders, were sold to outsiders (Appendix A, *infra*, p. 10).

Subsequent to the issuance of the additional capital stock, Richards Music suffered business losses, and it eventually was involved in a Chapter XI bankruptcy proceeding, with the result that respondent's stock in Richards Music became worthless (Appendix A, *infra*, pp. 10–11). Respondent treated the $80,000 loss he suffered on the worthlessness of this stock as an ordinary loss. In his deficiency notice, the Commissioner asserted that the loss was a capital loss.

The Tax Court held that the stock was not a capital asset in respondent's hands because he had purchased it to retain Richards Music as a client and to insure a continuing source of legal fees, rather than with the expectation of dividends or capital growth. It accordingly allowed respondent an ordinary loss. On appeal, the Sixth Circuit affirmed.

REASONS FOR GRANTING THE WRIT

The issue raised in this case is essentially the same, in a different setting, as that presented in the government's petition for a writ of certiorari in *United States v. Waterman, Largen & Co., Inc.*, filed this day.[3] In *Waterman, Largen*, the Court of Claims allowed an ordinary loss after finding that the loss of the taxpayer's client would have resulted in serious

[2] Respondent had earlier purchased 12,000 shares of Richards Music which are not here involved (Appendix A, *infra*, p. 10).

[3] Copies of our petition in *Waterman, Largen* are being served on counsel for respondent herein.

injury to its business. The court below allowed respondent an ordinary loss even though he made no showing as to extent of injury to his law practice that would have resulted from the loss of Richards Music as a client. Since, in our view, a business purpose for an acquisition of corporate stock, no matter how urgent, cannot convert the stock from a capital into a noncapital asset, we do not believe that the distinction is material to the disposition of the two cases.

CONCLUSION

For the reasons stated in our petition in *Waterman, Largon*, on which we here rely, the instant petition should also be granted.

Respectfully submitted.

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JULY 1970.

APPENDIX A

No. 19486

United States Court of Appeals for the Sixth Circuit

CHARLES W. STEADMAN AND DOROTHY F. STEADMAN, APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

On Appeal from the Opinion of the Tax Court of the United States

Decided April 10, 1970

Before PHILLIPS, Chief Judge, CELEBREZZE, Circuit Judge, and O'SULLIVAN, Senior Circuit Judge.

O'SULLIVAN, Senior Circuit Judge. This is an appeal by the Commissioner of Internal Revenue from a decision of the Tax Court reported as *Charles W. Steadman*, 50 T.C. 369 (1968). Therein the Tax Court held valid the taxpayers' claim of an ordinary loss deduction for the year 1962, in the amount of $80,000 being taxpayers' purchase price for shares of corporate stock which became worthless in the year 1962. The Commissioner contends here, as he did in the Tax Court, first that the loss did not occur in the year 1962; and second, that the loss was a capital loss which could not be deducted from ordinary income as a business loss. The Tax Court ruled against the Commissioner on both contentions. Five dissenters, however, held that the loss did not occur in the year 1962, but did not rule upon the Commissioner's second contention. They said:

"In view of the conclusion [that the loss did not occur in 1962] there is no need to consider whether petitioner sustained his burden of proof that the loss was a business loss * * *."

We affirm.

Charles Steadman was a partner in a Cleveland law firm. His practice was primarily in the field of corporate finance and organization. In the spring of 1960, one Paul E. Richards contacted Steadman with regard to a plan for the acquisition and amalgamation of several musical instrument companies into a single, integrated manufacturing and marketing organization. Richards offered Steadman the position of general counsel and assured him that he would remain general counsel of the proposed corporation so long as Richards retained control of its management. Based on the nature of the proposed organization, and the prospect of many acquisitions and mergers, generating substantial legal fees, Steadman estimated that something over $30,000 per year in legal fees would accrue to him as general counsel. Under Steadman's partnership agreement with his law firm, all of these fees, less a percentage to cover the overhead expenses of the law firm, would go to Steadman.

The establishment of the contemplated corporation was carried out as set forth in the Tax Court opinion, as follows:

"Petitioner accepted Paul Richard's offer and, as a first step in executing the plan, organized the Richards Music Corp. (herein referred to as Richards Music) as the principal corporate entity. Then, on December 30, 1960, the Blessing Band Instrument Co. was merged into Richards Music, and the stock of the Martin Band Instrument Co. and the assets of the Reynolds Band Instruments Co. were acquired by Richards Music. The resulting entity became

operational at this time with petitioner as its secretary, general counsel, and member of the board of directors. In early 1962, the name of Richards Music Corp. was changed to Richards Musical Instruments, Inc.

"To finance the merger and acquisition, Richards Music borrowed $750,000 from American Research & Development Corp. of Boston, Mass. (herein referred to as American Research), in exchange for 6-percent, convertible subordinate debentures, which were convertible into common stock of Richards Music at $3 per share.

"Immediately following the merger and acquisitions, the board of directors of Richards Music consisted of nine members, five (including petitioner) representing the shareholders, three representing American Research, and one representing Wurlitzer Co. which had acquired notes and debentures of Richards Music in return for the stock of the Martin Band Instrument Co."

The validity of Steadman's estimate of the yearly earnings that would come to him as general counsel for the newly formed corporation is not challenged; neither is the value of the service performed by Steadman and an associate during the years 1961 through 1961 questioned. Such value exceeded $30,000 in each year. Because of the company's financial problems, the actual payments to Steadman totalled $47,036.58 for these four years, as against the total value of the service of $144,615.50.

By the summer of 1961, it became apparent that further financing was critically necessary to complete plans for further acquisitions. American Research & Development Corp., which was already the holder of $750,000 face value of Richards Musical Instruments, Inc. convertible debentures, offered to provide additional financing by purchasing newly issued shares in

the amount of $350,000, conditioned upon an increase in the number of directors to ten, five to be selected by the debenture holders. Implicit in this offer was a bid by American Research for control of Richards Music. American Research made it clear that such control would be followed by a change in management and the concentration of legal activities in the Boston law firm handling the business of American Research. Steadman was thereby made aware that acceptance of the American Research offer and plan would likely cause him to lose his position and become assistant counsel of Richards Music. To maintain his position it was imperative that some other financing arrangement be secured. In response to American Research's offer, the Board of Richards Music passed a resolution authorizing the issuance of 140,000 new shares of capital stock in the amount of $350,000, but to be offered first to the shareholders of record, at $2.80 per share. Steadman was already the owner of 12,000 shares of Richards Music which he had earlier purchased. These shares are not here involved. The shareholders of record, other than Steadman, were willing to purchase only 70,000 shares. Through a New York brokerage house, Steadman arranged the purchase of the remaining 70,000 shares, 32,000 held for his own account and financed by a Cleveland bank's loan to Steadman. Steadman's loss of $80,000 when the shares he purchased for that amount became worthless is the subject matter of this litigation.

Subsequent to this purchase, Richards Music suffered business losses, the extent of which were not revealed fully until an external audit by Ernst & Ernst, covering the calendar year 1962, was furnished on March 27, 1963. This external audit revealed a net deficit in shareholder's equity of $456,109.19, a net

operating loss of over $1.3 million, and an excess of current liabilities over current assets of over $100,000. These figures supported the fears of the Board, aroused in December of 1962, that the management of Richards Music had been presenting the Board with false figures and that Richards Music was, in reality, in dire financial straits. The Board met in January of 1963, replaced Paul Richards as president and began consideration of what could then be done with Richards Music. Business operations continued through 1963, but the Ernst & Ernst audit for that year confirmed the fact that Richards Music had no prospect for continued existence. On April 15, 1964, a Chapter XI bankruptcy proceeding was filed in federal district court. Steadman's shares had become, and remained, worthless.

We consider the questions presented in this order:

1. The year of loss.

The Tax Court held that Steadman's $80,000 loss occurred in the year 1962. The Commissioner contends that it occurred in 1963. Resolution of such contest involves a finding of fact. The Tax Court found, as a matter of fact, that the loss occurred in 1962. Unless we can say that such finding was clearly erroneous, we are not at liberty to set it aside. *Commissioner v. Duberstein*, 363 U.S. 278, 289 (1960). The Commissioner's brief to this Court states the rule as follows:

> "The cases in this area are consistent with the Regulations; they have consistently held that when stock or securities become worthless is a question of fact to be determined from an examination of all the facts and circumstances of the case. It is generally agreed that no single factor is determinative of the issue (*Boehm v. Commissioner*, 326 U.S. 287 (1945)), and it is

equally well-settled that the burden of establishing worthlessness, as well as the year of its occurrence, is on the taxpayer (*Lincoln Bank & Trust Co. v. Commissioner*, 51 F.2d 78 (C.A. 6th, 1931)).

The Tax Court determined that the capital stock of Richards Music was worthless as of December 31, 1962. This finding was based upon the computed balance sheet prepared by Touche Ross covering the year 1962 and revealing a large net operating loss and the net deficit in the shareholders' equity. The Tax Court also noted that in appraising the stock's worth in current assets over current liabilities, account should be taken of the fact that a relatively large amount of the current assets consisted of unfinished goods in inventory. We do not consider that the Tax Court intended to hold that Richards Music was in net insolvency as of December 31, 1962. We read his pronouncement to be that those controlling the corporation in 1963 were not without hope that implementation of plans then underway would restore some worth to its shareholders' equity. These plans were carried out, and as they are set out in detail in the Tax Court opinion we will not detail them here. The Tax Court's view was that the plans of 1963 had for their primary objective the solvency of Richards and that the company's petition for reorganization [illegible] apparently that there must be a showing of an "identifiable event" which would confirm the [illegible]

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* The Tax Court's opinion recites:

"An external audit, dated March 7, 1963, prepared by Touche Ross and Trust as of December 31, 1962, revealed a net loss [illegible] for the year of $1,311,000, an excess of current liabilities over current assets of $1,090,000, and a net deficit in the shareholders' equity of $166,000. Of the $1,305,733 in current assets, $591,000 represented unfinished inventory and [illegible] consisted of cash."

loss. Disposing of this question, the Court quoted this language from its decision in *Sterling Morton*, 38 B.T.A. 1270 (1938):

> "There are, however, exceptional cases where the liabilities of a corporation are so greatly in excess of its assets and the nature of the assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders, so that, as to such cases the stock, obviously, has no liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can reasonably be said to have no potential value. Where both these factors are established, the mere fact that a date of an accidentifiable event in the corporation's life such as liquidation or receivership, will not, therefore, determine the worthlessness of the stock, for already its value has become finally extinct." 38 B.T.A. at 1279.

The Tax Court's crucial holding was that after 1962 there was no reasonable expectation of future profit to the shareholders of Richards Music, and that a prudent businessman would have ascertained the stock was worthless." The Commissioner here cites this Court's opinion in *Deeds v. Commissioner*, 47 F(2) 695 (6th Cir. 1931). It will be sufficient to say that there we affirmed the Board's finding of fact, and in *Morton v. Commissioner of Internal Revenue*, 112 F(2) 320, the Seventh Circuit affirmed the findings of fact by the B.T.A., saying:

> "The worthlessness of a stock as of a particular year is a question of fact requiring practical consideration of all the facts and circumstances, and each case must stand on its own facts. St. Louis Union Trust Co. v. United States, 8 Cir., 82 F2d 61, 66; Forbes v. Commissioner, 4 Cir. 62F.2d 571; and Industrial Rayon Corp. v. Commissioner, 6 Cir., 94 F2d 383. We of

course, are bound by the rule that where there is substantial evidence to support the Board's finding upon a question of fact, its decision of such a question is conclusive upon review, and the conclusions must be accepted. Helvering v. Rankin, 295 U.S. 123, 55 S. Ct. 732, 79 L.Ed. 1343; Palmer v. Commissioner, 302 U.S. 63, 58 S.Ct. 67, 82 L.Ed. 50; Helvering v. National Grocery Co., 304 U.S. 282, 294, 58 S.Ct. 932, 82 L.Ed. 1346; Sacks v. Commissioner, 4 Cir. 66 F.2d 308; and Jones v. Commissioner, 9 Cir., 103 F.2d 681, 684." 112 F(2) at 324.

We hold that substantial evidence supported the Tax Court's finding. It was not clearly erroneous.

2. Was the loss deductible from ordinary income.

Our earlier factual recital sets out the emergency that prompted Steadman to borrow $80,000 to purchase the 32,000 shares of Richards Music. He had already owned 12,000 shares as a capital investment, the loss of which is not claimed here. The only reasonable view that can be taken of Steadman's borrowing of $80,000 to acquire the shares here involved is that he did so to protect his position as general counsel for Richards Music and the earnings necessarily flowing from such position. Such was the holding of the Tax Court. The Commissioner recognized this in his statement to us that,

> "The taxpayer here, an attorney, purchased stock in a client corporation, not with the expectation of dividends or capital growth, but in order to retain the corporation as a client affording substantial fees for legal services."

Admittedly, if the company's 1961 needs had been financed by sale of new stock to American Research, holder of debentures, control of management would have gone to that concern and the legal work would have been transferred to a Boston law firm. In holding that Steadman's 32,000 shares of Richards Music

was not a capital asset, the loss of which could only be charged against capital gains, the Tax Court said:

> "Whether an asset normally considered capital in nature is an integral part of a taxpayer's business so as to render a loss suffered with respect to it deductible as an ordinary loss is essentially a fact question. In making this determination, it must be borne in mind that the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly so as to effectuate the basic congressional purpose. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46 (1955)." 50 T.C. at 379.

The question now before us has been presented in a variety of factual situations. In *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), the Supreme Court was dealing in "corn futures". In *Booth Newspapers, Inc.* v. *United States*, 303 F(2) 916 (U.S. Ct. of Claims, 1962) the Court of Claims held that stock purchased by newspaper publishers in a paper mill company to protect its paper supply was not a capital asset. The Court's opinion there produced the following syllabus:

> "If securities are purchased by a taxpayer as an integral and necessary act in conduct of his business, and continue to be so held until time of their sale, any loss incurred as result thereof may be fully deducted from gross income as a business expense or ordinary loss, but if an investment purpose motivated purchase or holding of securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of Internal Revenue Code, 26 U.S.C.A. (I.R.C. 1954) § 1221." 303 F(2) at 916.

We need not consider whether, had Richards Music survived to go on to a profitable future, and Steadman continued to hold his shares, they might have

become capital assets when holding them was no longer necessary to protect Steadman's business. However, whatever their value, the Tax Court held that they never acquired the status of capital assets during their short period of survival. The Tax Court's position here has been sustained in the following decisions of the United States Court of Claims, *Waterman, Larson & Co., Inc.* v. *United States*, 419 F.(2) 845 (U.S. Ct. of Claims, Nov. 14, 1969); *Pan Am. Agency Corporation, Inc.* v. *United States*, — F.(2) — (U.S. Ct. of Claims, 1969) and *F.S. Services, Inc.* v. *United States*, — F.(2) — (U.S. Ct. of Claims, 1969).

We hold that Steadman's $80,000 loss in 1962 was deductible from ordinary income.

The judgment of the Tax Court is affirmed.

APPENDIX B

United States Court of Appeals for the Sixth Circuit
No. 19,486

CHARLES W. STEADMAN AND DOROTHY F. STEADMAN,
PETITIONERS-APPELLEES

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

Before PHILLIPS, *Chief Judge*, CELEBREZZE, *Circuit Judge* and O'SULLIVAN, *Senior Circuit Judge*.

On appeal from a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

It is further ordered that Petitioners-Appellees recover from Respondent-Appellant the costs on appeal, as itemized below.

Entered by order of the Court.

CARL W. REUSS,
Clerk.

Costs: None.
Filed
April 19, 1950.

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